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SIPDIS

DEPARTMENT FOR EUR/ERA AND EUR/RPM

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TAGS: MARR PREL EUN USEU BRUSSELS

SUBJECT: BUILDING THE INTERNAL EUROPEAN DEFENSE MARKET: EU

TAKES NEXT STEPS

REF: A. BRUSSELS 4203 B. BRUSSELS 4202 C. BRUSSELS
3747 D. BRUSSELS 3611

Classified By: USEU Political Military Officer Jeremy Brenner for reasons 1.4 (b) and (d).

¶11. (U) Summary. The European Union is taking steps to consolidate the European defense equipment market. The European Defense Agency has established a code of conduct for defense procurement, and the EU is developing plans to match US levels of investment in defense research and development. A number of decisions will be made over the next six months concerning the standards and rules that will be applied for procurement. These decisions must be examined carefully because there is a lack of assured transparency in the process, and subsidies for R&D, and provisions for ad hoc arrangements could be detrimental to US interests. This message identifies the major initiatives now underway. They will be examined in greater detail in subsequent cables. End summary.

Be Careful what you wish for...

¶12. (C) The US faces a conundrum as the European Union takes steps to consolidate its defense equipment market. On the one hand, a number of the measures put forward by the European Defense Agency are necessary - if not sufficient - for the creation of a European Defense industry that can provide the effective military capabilities we have urged for decades. At the same time, some of these measures - if not closely monitored - could move the European Defense market away from a system that will be open and transparent toward a system that could be detrimental to US industry.

Building European Capabilities

¶13. (C) In order to build, buy and employ the long-sought capabilities to act credibly as a strategic global partner of the United States, "Europe" must overcome many internal challenges. The way in which these challenges are addressed will have significant implications for important US interests. In the defense capabilities area, the European Union is taking steps to harmonize European defense industrial output while creating a European common market for defense. One of the questions they face as they move ahead is how to create a competitive environment in which harmonization can take place while protecting their fledgling initiatives from better capitalized and more experienced (often US-owned) multinational defense firms? The answer, so far, suggests an approach to market development that will inject European Union capital into essential R&D activities, and might set proprietary standards inconsistent with those currently in use in NATO and the US. The reform effort threatens to hinder US access to future defense contracts. Careful monitoring of these developments will be critical to preventing damaging conflict, but it will be difficult to get a clear picture because of a lack of transparency.

The European Defense Agency

¶14. (U) The EDA as an institution is developing quickly. Beginning with a staff of 25, it has reached its full authorized staffing level of 80, though it can draw on national experts, giving it additional resources. After its creation in 2004, the Agency was to establish rules governing access to information thereby ensuring the same amount of transparency as already exists for other EU institutions. To date, this has not occurred. Existing transparency rules allow EU institutions to refuse access to documents that would undermine the protection of defense and military matters. Further, the EDA has stated that it views its role as "the instrument to achieve mutual transparency and accountability" for the implementation of the new defense procurement rules. The European Commission and the European Parliament each have a role in overseeing the development of this process. The Agency is also required to report regularly to the European Council. Still, the EDA is its own

watchdog for implementation of the Code of Conduct, meaning that there is currently no guarantee of transparency with respect to substantial EDA-driven changes within the European defense industry.

Code of Conduct

15. (U) The EDA's newly-announced code of conduct is broad and lacks specificity. It is a mutual guarantee of open defense markets by EU Member States that choose to participate on a reciprocal basis. There is no guarantee that contracts issued under the Code of Conduct will be open to American defense companies. The EDA leaves it up to each individual Member State to decide whether to issue contracts for defense equipment to non-EU companies. Member States must commit to participating in the Code of Conduct by April 12006. The Code is slated to go into effect in June. Work has already begun on the creation of an electronic bulletin board, where all defense contracts will be posted. The rules of access to this bulletin board will be an important indication of the openness of the system.

Ad Hoc Projects

16. (C) In addition to the Code of Conduct, the European defense equipment market will change substantially over the next few years by the formation of ad hoc defense projects within the context of the EDA. The EDA envisions that some projects will include all Member States and may be funded based on a Gross National Income scale. The Agency also envisions the possibility of a more selective group of ad hoc defense projects that would only be open to certain self-selected Member States with no requirement that other Member States be allowed to join. Further, it is unclear whether these "coalitions of the willing" for defense projects will be subject to the Code of Conduct. Decisions on the ad hoc projects may be reached on a qualified majority basis, which will reduce the influence of many smaller, pro-US Member States from "New Europe."

Standards and Practices

17. (C) The EDA will be drafting standards such as a Code of Best Practices in the supply chain to allow for the participation of small and medium sized businesses. The Agency will also develop standards for the security of information and/or security clearances. Further, the development of larger ad hoc defense projects could have the effect of creating a de facto EU standard for defense equipment that may or may not be compatible with NATO and/or the US. If the established standards are inconsistent with NATO standards, or will adversely affect the competitiveness of bids by US defense companies, only US political-level intervention is likely to be effective in altering EDA's course. Even at this early stage of development, it is unclear if US companies will have the same degree of access to requests for proposals/bids in the electronic marketplace and on electronic bulletin board that the EDA is establishing.

Toward a "Cartel" of National Producers?

18. (C) The EDA has stated that it does not intend to create a European preference or exclude US companies. However, the practical effect of the reform effort is that US defense companies must continue to merge or form joint ventures of convenience with European defense companies to remain competitive in Europe. (Note: Representatives of European industry argue to us that European companies in the US face the same situation. End note). If the Commission ensures that existing law is enforced, Member States will be required to give up the notion of supporting national or European champions as well as allowing politically-sensitive government-supported national enterprises to fend for themselves in the competitive marketplace. Because the Member States will ultimately decide the outcome of the EDA's initiatives, compromises will likely emerge between the forward-looking ideas of EDA and the protectionist tendencies of the Member States. Any lack of transparency of EDA defense procurement could combine with Member State governments' support for national suppliers to create an environment where cartel-like activity could be attractive to some.

Research and Development

19. (U) The EU has launched an effort to increase investment

in R&D across all sectors within the EU from 1.9% to 3% of GDP by 2010. This includes a focus on developing R&D and common programs in civilian-military applications that will involve funding from multiple sources such as the Commission, Member States or the EDA. The Commission has stated that the gap in research investment between the European Union and the United States is in excess of 120 billion Euros per year. The EU is attempting to address this gap with the adoption of "Lisbon-type" agenda for R&D that would include increasing the funding of programs with civilian-military overlap. The EU believes that Commission funding for civilian-military R&D programs, national defense funds from the Member States, funds from the European Defense Agency (EDA) and a proposed new European Security Research Program of Euro 1 billion will help close the gap in security research. The EU is currently laying the legal and budgetary groundwork to carry out its plan. The main obstacle remains the EU fiscal framework for 2007-2013 that has yet to be approved by the Member States. Despite the optimistic planning by EDA, under current political circumstances within the EU, the budget -- when approved -- is unlikely to provide new funding for R&D. The EU plan also depends upon greater R&D spending by Member States and private enterprise, and while targets have been set, implementation of the program has not begun.

Conclusion

¶110. (C) Clearly, any moves toward "Fortress Europe" by the EU and the EDA in the sensitive area of defense procurement will be detrimental to US economic and political interests. In anticipation of a negative US reaction, some in Europe are already referring to the "Buy America Act" and restrictive US licensing practices as justification for EDA countermeasures. The European Commission and Parliament are already raising issues of openness, potential business impact, and possible effects on NATO harmonization. It is clear the political debate in Brussels over how to build a coherent European defense market is far from over. (see septels). Still, the new and rapidly developing aspects of the European Union push to establish a more coherent European defense equipment market warrant close scrutiny, and may require political intervention in the event that the EU chooses a path that could damage US or NATO interests.

McKinley

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